Rothmans of Pall Mall Canada Limited

Annual Report 1978

Rothmans of Pall Mall Canada Limited

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The Annual Meeting of shareholders will be held at the Four Seasons Hotel (formerly the Hyatt Regency Hotel), 21 Avenue Road, Toronto, Ontario at 3:00 o'clock on Thursday, July 6, 1978.

Ce rapport peut être obtenu en français sur demande.

Rothmans of Pall Mall Canada Limited

CONSOLIDATED HIGHLIGHTS

(in thousands of dollars)

	1978	1977
Year Ended March 31		(restated)
SALES FROM CONTINUING OPERATIONS	**$779,898**	$753,673
EARNINGS:		
FROM CONTINUING OPERATIONS	**24,475**	19,383
BEFORE EXTRAORDINARY ITEMS	**19,384**	19,332
AFTER EXTRAORDINARY ITEMS	**14,266**	19,668
DIVIDENDS PAID:		
PREFERRED SHARES	**3,547**	3,581
COMMON SHARES	**3,028**	2,370
WORKING CAPITAL FROM CONTINUING OPERATIONS	**47,042**	37,610
CAPITAL EXPENDITURES	**26,056**	22,199
EARNINGS PER COMMON SHARE:		
FROM CONTINUING OPERATIONS	**4.58**	3.47
BEFORE EXTRAORDINARY ITEMS	**3.47**	3.46
AFTER EXTRAORDINARY ITEMS	**2.35**	3.53
At March 31		
WORKING CAPITAL	**118,467**	64,980
TOTAL ASSETS	**415,854**	432,494
LONG TERM DEBT	**49,242**	49,650
SHAREHOLDERS' EQUITY:		
AMOUNT	**117,054**	109,167
PER COMMON SHARE	**14.00**	12.24

Corporate Profile

The Company is a member of the world-wide Rothmans Group which operates 103 plants in 30 countries and whose products are sold in more than 180 countries. Rothmans of Pall Mall Canada Limited and its subsidiary companies are engaged in the production and sale of tobacco, beer and wine products and are involved in oil and gas operations.

Rothmans is Canada's second largest manufacturer and distributor of cigarettes and tobacco products. The Company's present cigarette brands are set out below:

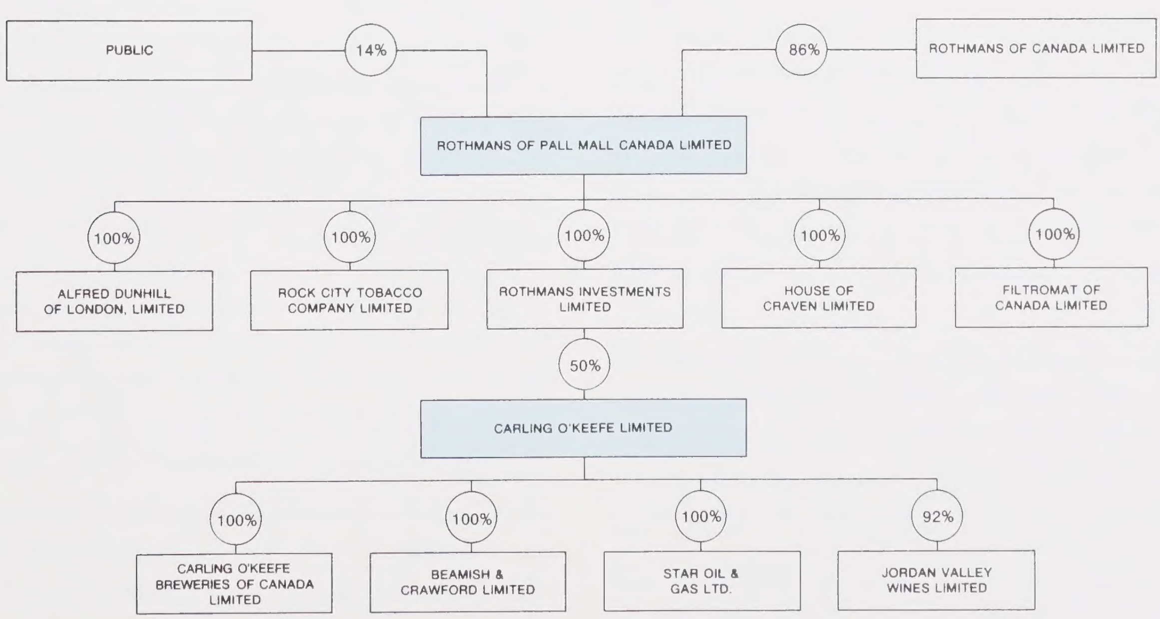
REGULAR LENGTH	*KING SIZE*		*LUXURY LENGTH*
Craven "A"	Rothmans	Craven Menthol	Peter Stuyvesant 100's
Craven "A" Special Mild	Rothmans Special Mild	Sportsman	Peter Stuyvesant 100's Menthol
Rothmans Special Mild	Number 7	Perilly's Private Blend	Dunhill Luxury Length
Sportsman	Number 7 Lights	Peter Stuyvesant	
Black Cat	Craven King Size	Dunhill	
	Craven "A" Special Mild	Dumont Select Mild	
	Craven Menthol Special Mild		

In addition, Rothmans sells fine cut tobacco, cigarette rolling devices and tubes for home use, imported pipe tobaccos, cigars and smokers' accessories. Tobacco manufacturing operations are carried out in plants located in Toronto and Quebec City and the Company has seventeen sales offices across Canada.

Carling O'Keefe Limited, a majority-owned subsidiary, operates eight breweries in Canada and one in the Republic of Ireland, producing such well known brands as Carling Black Label, Old Vienna, O'Keefe Ale, Carlsberg, Colt 45 and Highlite. Jordan Valley Wines Limited produces wine at seven Canadian wineries and Star Oil & Gas Ltd. is engaged in oil and gas operations in Canada and the United States.

The consolidated corporation is among the 100 largest companies in Canada and employs more than 5,300 people, paying annual salaries in excess of $100 million.

The following chart outlines the corporate relationship between your Company, its shareholders and its main subsidiaries.



(Percentages have been rounded.)

Directors' Report

PERFORMANCE

Excluding United States brewing operations and extraordinary items, earnings from continuing operations* showed marked improvement in the year ended March 31, 1978 and amounted to $24,475,000 or $4.58 per Common share. Both tobacco and brewing operations contributed to the 26 percent increase over last year's results. Earnings from tobacco operations increased 9 percent to $19,612,000 on a slightly reduced sales volume. The contribution from Carling O'Keefe Limited's continuing operations to your Company's after-tax earnings increased to $4,863,000 from $1,361,000 in 1977.

The Company's share of losses from the United States brewing subsidiary, Carling National Breweries, Inc., for the nine-month period prior to its sale in December 1977 was $5,091,000. Extraordinary losses and gains from brewing operations, including the loss on sale of Carling National, further reduced earnings by $5,118,000. Final consolidated earnings amounted to $14,266,000 or $2.35 per Common share, compared to $19,668,000 ($3.53 per Common share) in 1977.

During the past year, the dividend paid on Common shares was increased to $1.00 per share on an annual basis. This increase almost doubles the previous payout and is both warranted and sustainable based on projected earnings.

TOBACCO

Tobacco operations are the main contributor to the Company's earnings. Sales revenues increased to $398,751,000 in 1978 from $394,484,000 in spite of a marginal sales volume decline. Total industry sales for the same period also registered a slight reduction in volume.

The Canadian cigarette industry has been highly competitive in recent years as a result of a somewhat static total market and rapidly changing consumer preferences for 'milder' brands. During the past year, in response to this new development, your Company has successfully introduced several 'mild' products, well positioned within what has become the fastest growing segment of the market. The Company's largest brand, Rothmans King Size, has been complemented with the addition of Rothmans Special Mild in both king size and regular lengths. These products were introduced into national distribution in November of 1977. Sales performance for the new Rothmans Special Mild has been excellent.

Following its highly successful launch in late 1976, Craven "A" Special Mild King Size was extended into national distribution during April, 1977 and a regular length version added to the product line. In addition, Craven Menthol Special Mild was introduced into most major sales areas in January of 1978. This new brand activity, combined with increased overall sales of the parent brand Craven "A", provided the Craven family with a highly gratifying total sales volume increase of almost 13 percent.

Number 7 enjoys its greatest market penetration in Ontario and Western Canada. In order to provide a 'lighter' version of this product, Number 7 Lights King Size was introduced into Ontario and the Prairies in February of 1978 featuring a friendly "Hello Mildness" theme. Initial sales results for the new brand are encouraging.

With the exception of Craven "A", the overall effect of this new brand activity is to erode somewhat from sales of the Company's established full-flavour brands. However, we believe that our 'mild' cigarettes are now extremely well positioned to offset these losses and take an increasing share of the rapidly expanding 'mild' segment of the market.

In co-operation with the Federal Government, we and the other Canadian manufacturers have voluntarily agreed to limit our marketing expenditures. In addition, we are continuing our efforts to reduce the overall level of measurable smoke constituents of our products.

In order to improve Rothmans sales and earnings over the next several years, we will continue our concentrated efforts on improving our position within the industry and increasing the productivity of our operations. In line with these objectives, capital expenditures are expected

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*The continuing operations consist of tobacco, Canadian and Irish brewing, wine, and oil and gas operations. They do not include any U.S. operations, namely Carling National Breweries, Inc. and Century Importers Inc. which were sold during the 1978 fiscal year.

to increase to approximately $7.5 million in 1979 from the $3.3 million spent in 1978.

Both the Toronto and Quebec Union contracts were settled amicably during the past year and these will expire on December 20, 1978 and March 19, 1979, respectively.

Your Company continues to fall under Anti-Inflation Board pricing and profit constraints for the balance of the control period which will end on December 31, 1978.

During the past year, your management and Board of Directors have reformulated several of the Company's operating policies and plans. This year, for the first time, we are including in this Annual Report a section outlining our policies and plans relating to capital structure, capital expenditures, dividends and diversification and acquisitions. We believe that this information will assist shareholders and potential investors in evaluating the strength of our business and, in particular, the worth of their securities.

BREWING

The decision by the Board of Directors of Carling O'Keefe Limited to accept the cash offer of $30,000,000 for its wholly-owned subsidiary, Carling National Breweries, Inc., removes much of the uncertainty surrounding the future prospects of Carling O'Keefe.

Canadian brewing results now appear more promising than in the past few years and the oil and gas division continues to show excellent returns on the original investment. The wine industry in Canada continues to grow. Jordan Valley Wines Limited is the largest domestic producer within the industry. The quality of Canadian table wines has been improved substantially over the past several years and new brands have been introduced to compete in this market as grapes of different varieties have become available.

We believe that the outlook for your Company's investment in Carling O'Keefe has improved and that positive contributions to consolidated earnings are to be expected in the future.

We believe that it is important to remind shareholders that Carling O'Keefe has its own Board of Directors and that its financing and credit are totally separate from that of Rothmans. Because of this, the 'Policies and Plans' section later in the report speaks only to Rothmans and considers its interest in Carling O'Keefe as an investment.

DIRECTORS AND MANAGEMENT

During the year, the Rt. Hon. Lord Pritchard retired from the Board of Directors for health reasons and has been replaced by Sir David Nicolson, Chairman of Rothmans International Limited of London, England. In order to avoid any conflicts of interest which may result from the sale of his business to one of our competitors, Mr. Murray Koffler has resigned from the Board of Directors. A replacement Director will be nominated at the Annual Meeting of shareholders.

Mr. R. T. Lloyd, Vice President Administration, retired from the Company at the end of 1977, after forty years of service. During his years with the Company, Mr. Lloyd was involved in many areas of our operations and made an outstanding contribution to our success. We would like to extend our sincere best wishes for a healthy and happy retirement to Mr. Lloyd and his family.

Also during the year, Mr. R. W. Allan, formerly Comptroller of the Company, was appointed Vice President Materials Management and Mr. G. G. Norman was appointed Vice President Human Resources.

Our fellow directors join us in thanking all employees of the Company and its subsidiaries for their contribution to the continuing success of the business during the year. To our shareholders, we express our thanks for your continuing interest and support.

J. H. Devlin
Chairman of the Board

R. H. Hawkes
President and Chief Executive Officer

May 18, 1978.

Policies and Plans

INTRODUCTION

During this past year the Board of Directors and management of the Company have continued to formulate objectives relating to a number of key strategic and financial policy and planning issues which will have an important impact on the future of Rothmans. These policy and planning objectives relate to capital expenditures, target capital structure, dividend policy and diversification and acquisition policies. The purpose of introducing this new section into our Annual Report is to inform shareholders of the development of our planning efforts.

Our approach to business and financial planning is ongoing, and our present policies, while conceived with an eye toward the future, are not inflexible. Our plans are periodically reviewed in the context of changing capital market and business conditions and we will keep shareholders aware of any major policy revisions which become necessary as conditions change.

CAPITAL EXPENDITURES

Based on budgets developed earlier this year, we anticipate capital expenditures for our tobacco operations of approximately \$7.5 million for additions and improvements to facilities during the 1979 fiscal year. In addition, we will have commitments for capital expenditures of less than \$1 million which relate to projects already begun or expected to be undertaken during 1979 but for which no cash outlay will be required during 1979.

We anticipate that the cash flow from tobacco operations over the next few years will be sufficient to finance fully our capital expenditures. Consequently, in the absence of any major unanticipated new investment opportunities, we expect no significant additional financing requirements in the near future.

CAPITAL STRUCTURE

In establishing financing guidelines for Rothmans, management believes that shareholders benefit from prudent use of debt because of the tax benefits that leverage provides and the lower after-tax cost of debt relative to common equity. At the same time, we recognize the importance of maintaining an adequate degree of financing flexibility and a sound financial base to support the Company's current operations and anticipated expansion.

After undertaking a comprehensive review of capital market conditions and considering a number of important aspects of our operations, we have established as our target for tobacco operations a ratio of debt-to-total capital of 45-50 percent at fiscal year end. Our analysis has excluded the investment in Carling O'Keefe and considered only the tobacco operations capital structure because of Carling O'Keefe's independent financing. Our debt-to-capital ratios over the period 1974-1978 are shown on the following page.

Consequently, in order to achieve our target debt ratio of 45-50 percent, we expect to moderate our relative use of debt in the future and anticipate reaching our target by mid-1979.

Because of large seasonal borrowings at our March 31 year end, our average debt ratio for the year is lower than that at fiscal year-end. For example, our average debt-to-capital ratio for 1978 was 49 percent, compared

DEBT-TO-TOTAL CAPITAL
(Dollars in Millions)

	As At Fiscal Year-End				
	1978	1977	1976	1975	1974
Total Interest-Bearing Debt	**78.4**	76.0	76.6	71.6	71.4
Total Capital*	**151.4**	135.7	123.2	105.9	93.8
Debt-to-Capital Ratio	**52%**	56%	62%	68%	76%

* Capital includes all interest-bearing debt, deferred taxes, preferred shares and common shareholders' equity (excluding the investment in Carling O'Keefe Limited on the equity basis).

with 52 percent at fiscal year-end. Therefore, our target debt ratio of 45-50 percent at March 31 translates into a slightly lower average debt ratio. We believe that this target capital structure will continue to provide our shareholders with the benefits of financial leverage while reducing the overall level of financial risk in our tobacco operations.

DIVIDEND POLICY

On December 19, 1977, your Board of Directors approved an increase in the annual Common dividend to $1.00 per share. This increase, which was effective with the March 1978 payment, makes our payout approximately double the previous level. This payout has been established in the context of the anticipated profitability and internal financing requirements of our tobacco operations for the next five years, and we believe the increase is warranted and sustainable on this basis. In arriving at this conclusion, no consideration has been given to the anticipated improvement in Carling O'Keefe earnings which will accrue as a result of the sale of its U.S. interests. We plan to continually review our dividend policy and you will be informed should that policy be revised.

DIVERSIFICATION AND ACQUISITION POLICY

At the present time, management is establishing a programme to examine opportunities for future investment both for our existing businesses and for possible diversification as well. We are presently determining standards to be used in the evaluation of future diversification or acquisitions.

In viewing potential investments, we intend to pursue only the highest quality, profitable growth opportunities. Our major consideration, as in any of our capital investment decisions, is the expected cash flow rate of return on the outlay required for such investment. Once our standards are formalized to a greater degree, they will be communicated to our shareholders.

Review of Tobacco Operations

This year the Annual Report contains more financial information relating to tobacco operations than has been released in the past. We hope that this information will aid shareholders in their evaluation of our performance. While the management of Rothmans uses several different methods to measure and evaluate operating profitability, we believe that our performance is best measured in terms of the return on total capital invested in the Company. We define the return on capital as net operating profits after tax, divided by average total capital employed.

ANALYSIS OF PERFORMANCE
TOBACCO OPERATIONS
($000)

	Fiscal Year 1978	1977	1976	1975	1974
Average Total Capital Employed					
Average Interest-Bearing Debt - - - - -	**$ 65,905**	$ 69,680	$ 67,441	$65,846	$57,110
Average Deferred Taxes - - - - - - - -	**6,563**	5,910	4,275	3,174	2,235
Average Shareholders' Equity* - - - - -	**60,897**	47,999	35,248	25,311	18,484
	$133,365	$123,589	$106,964	$94,331	$77,829
*Net Operating Profits After Tax***					
Earnings Before Extraordinary Items - -	**$ 19,612**	$ 18,022	$ 21,729	$17,328	$12,637
Change in Deferred Taxes - - - - - - -	**66**	1,427	1,566	1,203	1,199
After Tax Interest Expense - - - - - - -	**3,027**	3,581	3,370	3,434	2,726
	$ 22,705	$ 23,030	$ 26,665	$21,965	$16,562
Return on Average Total Capital Employed - -	**17.0%**	18.6%	24.9%	23.3%	21.3%

* Average shareholders' equity for tobacco is computed from total shareholders' equity minus the investment in Carling O'Keefe Limited on the equity basis.

** Net operating profits after tax represent the Company's profits before financing charges but after taxes to be paid.

To fully incorporate the effect of seasonal financing requirements on capital employed, we have computed average capital on the basis of monthly averages for debt, deferred taxes, and shareholders' equity. We include deferred taxes as part of capital because this represents cash invested in the Company, upon which a return should be earned. Similarly, we include the increase in deferred taxes in operating profits since this increase constitutes part of the real cash return to our shareholders.

The tobacco operations' return on capital of 17% is substantially above our estimate of the minimum acceptable return for tobacco operations of approximately 11%. This minimum return is a weighted average of current debt and preferred share replacement costs and our estimate of the rate of return currently expected by investors in our common shares.

The following table and explanatory notes provide a more detailed view of factors which influenced tobacco operations and profitability in the past year.

YEAR ENDED MARCH 31 (in thousands of dollars)	1978	1977	INCREASE (DECREASE)
SALES:			
Cigarette division	$386,204	$381,241	1 3%
Fine cut division	7,586	8,368	(9 3)
Dunhill division	4,961	4,875	1.8
	398,751	394,484	1.1
EARNINGS:			
Before income taxes	32,131	31,644	1 5
After income taxes	19,612	18,022	8.8

SALES:

(i) Cigarette division—

The gain in sales revenue was attributable to selling price increases implemented in March and December, 1977. The Company's unit cigarette sales were 16,877 million, a decline of 1.9 percent. Last year's sales of 17,209 million were somewhat inflated by higher than normal purchases by the trade prior to the Government of Canada budget at the end of March 1977.

Despite the lower overall sales volume, the Craven family again showed significant growth in unit sales. Led by Craven "A" Special Mild in both king size and regular length and by Craven "A" regular length, the family achieved an overall increase of almost 13 percent.

Rothmans Special Mild in king size and regular lengths was first introduced in June 1977 and is now in national distribution. Acceptance of this brand has been extremely encouraging and it is anticipated that its growth pattern will continue.

In the last quarter of the 1978 fiscal year, two further brand extensions into the mild segment were introduced, Craven Menthol Special Mild and Number 7 Lights. Initial response to both brands has been excellent.

The 1978 year was again a period of vigorous competitive activity in the Canadian cigarette industry, highlighted by further brand extensions in the growing mild segment. From a relatively small base a few years ago, cigarettes having readings of less than 15 mg. of 'tar' and 1.1 mg. of nicotine now represent approximately 42 percent of total industry sales. It is anticipated that this trend will continue in the foreseeable future.

Industry sales for 1978 were 61,844 million compared to 62,089 million last year, a decline of 0.4 percent. Because of the many new brand introductions, the sales incentives offered by some companies and the spread in timing of the manufacturers' price increases, individual company sales and market shares were very difficult to assess.

(ii) Fine cut division—

The decline in sales revenue from fine cut tobacco, cigarette tubes and cigarette rolling devices for home use resulted from reduced sales volumes. Selling price increases for tobacco and tubes in April 1977 were a partial offsetting factor.

Unit sales of fine cut tobacco amounted to 1,541,000 pounds, down by 8.1 percent from last year's 1,676,000 pounds. Because of a supply problem, sales of cigarette rolling devices declined by over 45 percent.

(iii) Dunhill division—

The 1.8 percent gain in sales revenue from imported pipe tobacco, cigars and smokers' accessories reflected both increased sales volumes for tobacco and lighters and selling price increases for most products.

Unit sales of pipe tobacco were 328,000 pounds compared to 318,000 in 1977, an increase of 3.1 percent. Lighter sales showed a gain of 15 percent.

EARNINGS BEFORE INCOME TAXES:

	Year ended March 31	
	1978	1977
Sales	100.0%	100.0%
Excise and sales taxes	53.9	55.5
Net sales	46.1	44.5
Costs:		
Raw materials and manufacturing	26.2	25.5
Marketing and distribution	8.0	7.3
Administrative and general	2.5	2.1
Interest	1.3	1.6
	38.0	36.5
Earnings before income taxes	8.1%	8.0%

(i) Excise and sales taxes—
This category is comprised of the three federal levies—excise duty, sales tax and excise tax. There were no changes in rates during 1978 but the amount of sales tax per pack of cigarettes went up marginally as a result of the Company's selling price increase in December. Together, these taxes now amount to 25.8 cents and 32.3 cents per pack of 20 and 25 king size cigarettes respectively. The most significant portion of the Company's federal taxes is related to unit cigarette sales. Since volume was lower in 1978, total taxes paid of $215,034,000 declined by 1.7 percent from last year.

At the retail level, the selling price of cigarettes also includes taxes levied by the provinces and territories. During the year ended March 31, 1978, there were five provincial tobacco tax increases, including two each in Ontario and Newfoundland. The Ontario increases amounted to almost 10 cents per pack of 25 cigarettes, while Newfoundland totalled just under 9 cents. The other provincial increase was in Saskatchewan (4 cents). Subsequent to the year-end, British Columbia, Manitoba, Quebec and New Brunswick also raised their taxes by 12, 5, 7, and 7.5 cents respectively. At the present time, provincial taxes range from 8 cents per pack of 25 in Alberta to 46 cents in Newfoundland. Together, federal and provincial taxes represent between 40 and 65 percent of the retail selling price of a package of cigarettes.

(ii) Raw materials and manufacturing expenses—
There are four major elements of expense in this category—leaf tobacco, packaging materials, direct labour and manufacturing overheads. The total charge against earnings amounted to $104,223,000 in 1978, an increase of 3.6 percent over last year despite generally lower sales volume.

The average cost of leaf tobacco charged to earnings was $1.20 per pound, compared to $1.17 in 1977. The small increase reflects the fact that prices paid by the Company for Ontario flue-cured tobacco, its major source of supply, remained relatively constant for the immediately preceding two years.

Auctions of the 1977 Ontario crop were completed in April 1978. Sales totalled 205 million pounds compared to only 159 million last year. The overall average price paid at the auctions was higher than the minimum price guaranteed by the four major Canadian tobacco manufacturers. The manufacturers have agreed to contribute a total of approximately $9.7 million to an export rebate fund to encourage overseas sales of flue-cured tobacco. Including its share of the fund, the Company's cost for Ontario leaf averaged $1.17 per pound. The cost of purchases up to March 31, 1978 are included in inventory.

The Company also purchases leaf tobacco in Quebec and the Maritime provinces. In total, purchases made during the year ended March 31, 1978 represented approximately 30 percent of the leaf sold in these areas.

Packaging materials consist of all raw materials with the exception of leaf tobacco. Paper and board products are the most significant components. In total, packaging material costs charged against earnings in 1978 amounted to approximately $27.3 million.

New one-year labour contracts for both plants were ratified during the year and approved by the Anti-Inflation Board. The contracts expire on December 20, 1978 at Toronto and March 19, 1979 at Quebec City.

Manufacturing overhead costs again showed significant increases in 1978. Overall, the total incurred during the year was about 13 percent higher than last year.

(iii) Marketing and distribution expenses—
This category includes selling, advertising, freight and warehousing costs. In total, these expenses amounted to $32,037,000 in 1978, up by 10.9 percent from last year.

Increased selling expenses reflected additional staff in the sales organization, higher salary and related fringe benefit costs, and increased travel and vehicle costs for salesmen. Higher advertising and promotion costs were primarily related to the introduction of new brands (Rothmans Special Mild, Craven Menthol Special Mild and Number 7 Lights) and the extension to national distribution of Craven "A" Special Mild.

Freight expenses were slightly lower than in 1977, as a result of both lower sales volumes and savings realized from changes in distribution methods. Increases in freight rates charged by carriers was a partial offsetting factor.

Warehousing expenses increased because of higher salary, fringe benefit and building operating costs.

(iv) Administrative and general expenses—
This category includes costs of the Company's administrative departments together with general corporate expenses. In total, these costs amounted to $9,950,000 in 1978, compared to $8,302,000 last year. In addition to higher salary and related fringe benefit costs, major factors accounting for the increase were write-offs of both packaging material and finished goods inventories, provincial capital taxes and data processing costs.

(v) Interest expense—
Interest and expense on both short and long term indebtedness was $908,000 lower in 1978. The major factor was a lower interest cost on short term borrowings, as evidenced by the reduction in the prime bank rate from 10¼% at the beginning of the 1977 fiscal year to the 8¼% rate which prevailed throughout the greater part of 1978. In addition, purchases of Debentures to satisfy sinking fund requirements reduced interest costs on long term debt.

INCOME TAXES:

The 1978 income tax provision amounted to $12,519,000 or 39 percent of earnings before tax. The comparable effective tax rate last year was 43 percent. Both years' provisions reflect the lower federal tax rate on manufacturing and processing profits and the 5% investment tax credit. The 1978 rate was significantly lower because of the 3% inventory allowance recently enacted by the Government of Canada.

The Company follows the tax allocation basis of accounting for income taxes for all timing differences between accounting and taxable income. The major timing difference in both years was the excess of capital cost allowance claimable for income tax purposes over depreciation recorded in the accounts.

WORKING CAPITAL:

Working capital from tobacco operations amounted to $69,028,000 at March 31, 1978, an increase of $12,973,000 during the year. The major contributing factors were earnings of $19,612,000 and non-cash charges against earnings of $3,958,000 (of which $3,932,000 was depreciation). Working capital was decreased by capital expenditures of $3,282,000, dividends of $6,575,000 and retirement of long term debt of $1,533,000.

Major capital expenditures for the year related to production equipment and facilities and the replacement of salesmens' vehicles.

Depreciation expense of $3,932,000 for 1978 compared to $3,685,000 last year. The Company depreciates capital assets on the straight-line basis over the estimated service lives of the assets.

Dividends paid were $624,000 higher than in 1977, primarily as a result of increases in the amount paid per Common share. The quarterly dividend rate was increased from 13½ cents to 14.3 cents for the December 1977 distribution and was further raised to 25 cents ($1.00 per annum) in March 1978.

EARNINGS FROM TOBACCO OPERATIONS

(in thousands of dollars)

	Year ended March 31	
	1978	1977
Income:		
Sales	**$398,751**	$394,484
Excise and sales taxes	**215,034**	218,792
	183,717	175,692
Costs:		
Raw materials and manufacturing	**104,223**	100,576
Marketing and distribution	**32,037**	28,886
Administrative and general	**9,950**	8,302
Interest and expense on long term debt	**2,783**	2,920
Other interest	**2,593**	3,364
	151,586	144,048
Earnings before income taxes	**32,131**	31,644
Income taxes:		
Current	**12,453**	12,195
Deferred	**66**	1,427
	12,519	13,622
Earnings for the year	**$ 19,612**	$ 18,022

CHANGES IN FINANCIAL POSITION OF TOBACCO OPERATIONS

(in thousands of dollars)

	Year ended March 31	
	1978	1977
Working capital was increased by:		
Earnings from tobacco operations	**$ 19,612**	$ 18,022
Depreciation	**3,932**	3,685
Other items not requiring working capital	**26**	1,412
Working capital from operations	**23,570**	23,119
Proceeds on disposal of property, plant and equipment	**688**	87
Issue of Common shares	**566**	—
	24,824	23,206
Working capital was decreased by:		
Additions to property, plant and equipment	**3,282**	4,355
Reduction of long term debt	**1,533**	1,508
Purchase of First Preferred shares	**420**	407
Dividends:		
Preferred shares	**3,547**	3,581
Common shares	**3,028**	2,370
Other	**41**	41
	11,851	12,262
Increase in working capital	**12,973**	10,944
Working capital at beginning of year	**56,055**	45,111
Working capital at end of year	**$ 69,028**	$ 56,055

FINANCIAL POSITION OF TOBACCO OPERATIONS

(in thousands of dollars)

	March 31 1978	March 31 1977
ASSETS		
Current assets:		
Accounts receivable	**$ 23,566**	$ 18,701
Inventories	**124,680**	113,613
Prepaid expenses	**1,095**	1,208
Total current assets	**149,341**	133,522
Investment in Carling O'Keefe Limited, at equity	**50,485**	55,780
Property, plant and equipment, at cost	**60,975**	59,622
Less: Accumulated depreciation	**33,100**	30,504
	27,875	29,118
Other assets	**714**	796
	$228,415	$219,216
LIABILITIES		
Current liabilities:		
Bank indebtedness and notes payable	**$ 52,239**	$ 48,226
Accounts payable and accrued liabilities	**15,321**	12,464
Income taxes	**259**	3,166
Excise, sales and other taxes	**12,494**	13,611
Total current liabilities	**80,313**	77,467
Long term debt	**24,650**	26,250
Total liabilities	**104,963**	103,717
DEFERRED INCOME TAXES	**6,398**	6,332
SHAREHOLDERS' EQUITY		
Capital stock:		
Preferred shares	**52,747**	53,251
Common shares	**4,159**	3,590
	56,906	56,841
Retained earnings	**60,148**	52,326
Total shareholders' equity	**117,054**	109,167
	$228,415	$219,216

Review of Brewing Operations

In order to provide a consistent approach in our review of brewing operations we are including return on average total capital employed figures for Carling O'Keefe's continuing operations.

ANALYSIS OF PERFORMANCE
BREWING CONTINUING OPERATIONS
($000)

	Fiscal Year				
Average Total Capital Employed	**1978**	1977	1976	1975	1974
Average Interest-Bearing Debt- - -	**$ 43,000**	$ 55,747	$ 49,569	$ 47,841	$ 54,840
Average Minority Interest - - - -	**1,690**	1,681	2,554	3,354	3,284
Average Deferred Taxes - - - -	**19,781**	16,383	14,869	13,686	12,433
Average Shareholders' Equity* - - -	**123,963**	102,906	107,583	113,984	114,807
	$188,434	$176,717	$174,575	$178,865	$185,364
Net Operating Profits After Tax					
Earnings Before Extraordinary Items -	**$ 11,809**	$ 4,833	$ 10,334	$ 7,796	$ 1,576
Change in Deferred Taxes - - - -	**2,578**	2,169	858	1,509	996
After Tax Interest Expense - - - -	**1,433**	1,509	1,497	1,703	1,774
	$ 15,820	$ 8,511	$ 12,689	$ 11,008	$ 4,346
Return on Average Total Capital Employed-	**8.4%**	4.8%	7.3%	6.2%	2.3%

*Average shareholders' equity for brewing continuing operations is computed from total shareholders' equity minus the investment in United States operations on the equity basis.

The following table and explanatory notes provide more detail about the factors which influenced brewing operations and profitability in the past year.

CONTINUING OPERATIONS

YEAR ENDED MARCH 31 (in thousands)	1978	1977	INCREASE (DECREASE)
SALES VOLUME:		(restated)	
Beer (barrels)—			
Canada - - - - - - - - - - - - - - - - - -	4,174	4,259	(2.0)%
Ireland - - - - - - - - - - - - - - - - - -	217	182	19.2
	4,391	4,441	(1.1)
Wine (gallons) - - - - - - - - - - - - - - - -	4,870	4,806	1.3
Oil and gas (barrels and equivalent) - - - - - - -	1,114	1,211	(8.0)
SALES:			
Beer—			
Canada - - - - - - - - - - - - - - - - - -	$317,322	$304,797	4.1
Ireland - - - - - - - - - - - - - - - - - -	25,123	18,936	32.7
	342,445	323,733	5.8
Wine - - - - - - - - - - - - - - - - - - -	31,904	29,323	8.8
Oil and gas - - - - - - - - - - - - - - - -	6,798	6,133	10.8
	381,147	359,189	6.1
EARNINGS:			
Before income taxes:			
Beer—			
Canada - - - - - - - - - - - - - - - -	12,627	6,816	85.3
Ireland - - - - - - - - - - - - - - - -	1,584	95	*
	14,211	6,911	*
Wine - - - - - - - - - - - - - - - - -	2,383	390	*
Oil and gas - - - - - - - - - - - - - - -	4,179	3,948	5.9
	20,773	11,249	84.7
Corporate income (expense)—net - - - - - - -	1,761	(234)	*
Interest expense - - - - - - - - - - - - - -	(2,755)	(2,988)	(7.8)
	19,779	8,027	*
After income taxes - - - - - - - - - - - - -	11,809	4,833	*

*more than 100%

CANADIAN BREWING:

In Canadian brewing operations, the lower sales volume reflects both the sale of Doran's operations in June 1977 and a small decline in Carling O'Keefe's share of the market. The slow rate of growth in Canadian industry beer sales, which has existed since 1974, continued during the 1978 fiscal year with sales volume increasing only marginally (1 percent) over the previous year. Earnings, however, showed a significant improvement due to selling price increases and efficiencies resulting from the sale of the Waterloo brewery during the year.

IRISH BREWING:

Sales volume, sales revenue and earnings of the Irish brewing subsidiary increased substantially, reflecting a larger share of a growing market and improved profit margins as a result of a selling price increase.

WINE:

Earnings from Canadian wine operations showed a significant improvement in 1978, reflecting price increases received, a better sales mix with a trend to more profitable brands and a substantial reduction in overheads due to an improved cost control programme.

OIL AND GAS:

Sales revenue and earnings from oil and gas operations were both higher during the year as a result of increased selling prices. Lower sales volume was a partial offsetting factor.

CORPORATE:

Royalty income from the sale of Carling Black Label under franchise agreements in certain overseas markets increased by 26.3 percent to $1,773,000. This increase reflected higher royalty rates and favourable foreign exchange factors. The sales volume was approximately the same as in the 1977 fiscal year.

UNITED STATES BREWING OPERATIONS:

On December 30, 1977, Carling O'Keefe Limited sold its United States brewing subsidiary, Carling National Breweries, Inc., for $30 million to an associated company of the Rothmans World Group. In the nine months of the 1978 fiscal year prior to the sale, an operating loss of $10,157,000 was incurred. This compared to a loss of $101,000 for the year ended March 31, 1977.

As a result of the loss, earnings of Carling O'Keefe Limited before extraordinary items were reduced to $1,652,000, compared to $4,732,000 last year.

EXTRAORDINARY ITEMS:

There were three items in 1978 which resulted in a net extraordinary loss of $10,211,000, reducing final consolidated results to a loss of $8,559,000. In 1977, a tax reduction of $670,000 arising from utilization of a loss carry-forward by the United States brewing subsidiary increased final consolidated earnings to $5,402,000.

The extraordinary items in 1978 were:

Loss on sale of investment in United States brewing subsidiary	$(12,093,000)
Gain on sale of Canadian brewery assets and sundry property	3,722,000
Unamortized excess cost of shares of Le Club de Hockey Les Nordiques Inc. written off	(1,840,000)
	$(10,211,000)

A copy of the 1978 Annual Report for Carling O'Keefe Limited is enclosed to provide additional and more detailed information on that company's consolidated operations.

Consolidated Statement of Earnings

(in thousands of dollars)

	Year ended March 31 1978	1977 (restated) (Note 3)
Income:		
Sales	**$779,898**	$753,673
Excise and sales taxes	**338,348**	333,063
	441,550	420,610
Investment and other income	**4,470**	3,570
	446,020	424,180
Costs:		
Raw materials and manufacturing	**240,667**	235,490
Marketing and distribution	**117,784**	114,204
Administrative and general	**28,123**	25,392
Interest and expense on long term debt	**4,348**	4,321
Other interest	**3,783**	4,951
Foreign exchange	**(678)**	180
	394,027	384,538
	51,993	39,642
Income taxes:		
Current	**17,845**	13,220
Deferred	**2,644**	3,596
	20,489	16,816
	31,504	22,826
Minority interest (Note 4)	**7,029**	3,443
EARNINGS FROM CONTINUING OPERATIONS	**24,475**	19,383
Loss of $10,157 (1977—$101) from operations of former United States brewing subsidiary, less minority interest of $5,066 (1977—$50) (Note 3)	**(5,091)**	(51)
EARNINGS BEFORE EXTRAORDINARY ITEMS	**19,384**	19,332
Extraordinary items:		
Loss on sale of investment in United States brewing subsidiary (Note 3)	**(12,093)**	—
Gain on sale of Canadian brewery assets and sundry property, less income taxes of $2,253	**3,722**	—
Unamortized excess cost of shares of Le Club de Hockey Les Nordiques Inc. written off	**(1,840)**	—
Tax reduction arising from utilization of loss carry-forward in former United States brewing subsidiary	**—**	670
	(10,211)	670
Minority interest	**(5,093)**	334
	(5,118)	336
EARNINGS FOR THE YEAR	**$ 14,266**	$ 19,668
Earnings per Common share (Note 5):		
From continuing operations	**$4.58**	$3.47
Before extraordinary items	**$3.47**	$3.46
After extraordinary items	**$2.35**	$3.53

Consolidated Statement of Retained Earnings

(in thousands of dollars)

	Year ended March 31	
	1978	1977
Balance at beginning of year	$ 52,326	$ 38,384
Earnings for the year	14,266	19,668
Excess of par value over cost of First Preferred shares purchased for cancellation (Note 9)	80	163
Excess of par value over cost of preference shares purchased for cancellation by Carling O'Keefe Limited, less minority interest	51	62
	66,723	58,277
Dividends paid:		
Preferred shares—		
First Preferred shares, Series A ($6.85 per share)	1,106	1,140
Second Preferred shares ($1.32½ per share)	2,441	2,441
	3,547	3,581
Common shares (1978—66.3¢ per share; 1977—52¢)	3,028	2,370
	6,575	5,951
Balance at end of year	$ 60,148	$ 52,326

Consolidated Statement of Changes in Financial Position

(in thousands of dollars)

	Year Ended March 31 1978	Year Ended March 31 1977 (restated) (Note 3)
Working capital was increased by:		
Earnings from continuing operations before extraordinary items	**$ 24,475**	$ 19,383
Depreciation	**12,367**	11,397
Minority interest in earnings from continuing operations	**7,029**	3,443
Other items not requiring working capital	**3,171**	3,387
Working capital from continuing operations	**47,042**	37,610
Proceeds from sale of—		
United States brewing subsidiary (Note 3)	**29,765**	—
Canadian brewery assets and sundry property, less mortgage of $6,885	**10,377**	—
Working capital from extraordinary items	**40,142**	—
Proceeds on disposal of property, plant and equipment and other assets	**2,648**	2,388
Issue of term bank loan (Note 8)	**7,000**	—
Issue of Common shares (Note 9)	**566**	—
Current portion of mortgage receivable	**—**	3,100
	97,398	43,098
Working capital was decreased by:		
Additions to property, plant and equipment	**26,056**	22,199
Additions to other assets	**681**	3,997
Purchase of shares of subsidiary company for $1,639 cash, plus working capital deficiency of $365	**—**	2,004
Increase in advances to former United States brewing subsidiary (Note 3)	**1,105**	560
Reduction of long term debt	**6,772**	4,993
Purchase of First Preferred shares	**420**	407
Dividends—		
Preferred shares	**3,547**	3,581
Common shares	**3,028**	2,370
By subsidiary companies to minority shareholders	**2,107**	2,125
Other	**195**	173
	43,911	42,409
Increase in working capital	**53,487**	689
Working capital at beginning of year	**64,980**	64,291
Working capital at end of year	**$118,467**	$ 64,980

ROTHMANS OF PALL MALL CANADA LIMITED
AND SUBSIDIARY COMPANIES

Consolidated Balance Sheet

(in thousands of dollars)

	March 31 1978	March 31 1977 (restated) (Note 3)
ASSETS		
Current assets:		
Cash and short term investments, at cost which approximates market	**$ 16,993**	$ 1,859
Accounts receivable	**50,554**	44,941
Recoverable income taxes	**664**	1,348
Inventories	**171,650**	162,231
Prepaid expenses	**4,417**	3,784
Total current assets	**244,278**	214,163
Investment in United States brewing subsidiary, at equity (Note 3)	**—**	50,910
Property, plant and equipment, at cost	**268,737**	262,764
Less: Accumulated depreciation	**123,227**	125,855
	145,510	136,909
Other assets (Note 6)	**26,066**	30,512
	$415,854	$432,494
LIABILITIES		
Current liabilities:		
Bank indebtedness and notes payable (Note 7)	**$ 54,508**	$ 80,946
Accounts payable and accrued liabilities	**46,566**	43,864
Income taxes	**4,623**	4,071
Excise, sales and other taxes	**19,589**	19,774
Dividends payable to minority interest	**525**	528
Total current liabilities	**125,811**	149,183
Long term debt (Note 8)	**49,242**	49,650
Total liabilities	**175,053**	198,833
DEFERRED INCOME TAXES	**28,493**	23,799
MINORITY INTEREST IN SUBSIDIARY COMPANIES (Note 4)	**95,254**	100,695
SHAREHOLDERS' EQUITY		
Capital stock (Note 9):		
Preferred shares	**52,747**	53,251
Common shares	**4,159**	3,590
	56,906	56,841
Retained earnings (Notes 10 and 14)	**60,148**	52,326
Total shareholders' equity	**117,054**	109,167
	$ 415,854	$432,494

APPROVED BY THE BOARD:

J. H. DEVLIN, *Director*

R. H. HAWKES, *Director*

ROTHMANS OF PALL MALL CANADA LIMITED
AND SUBSIDIARY COMPANIES

Line of Business Data
(in thousands of dollars)

CONSOLIDATED OPERATING RESULTS—CONTINUING OPERATIONS

	Year ended March 31					
	Tobacco		Brewing		Total	
	1978	1977	**1978**	1977 (restated)	**1978**	1977 (restated)
INCOME:						
Sales	**$398,751**	$394,484	**$381,147**	$359,189	**$779,898**	$753,673
Excise and sales taxes	**215,034**	218,792	**123,314**	114,271	**338,348**	333,063
	183,717	175,692	**257,833**	244,918	**441,550**	420,610
Investment and other income	**—**	—	**4,470**	3,570	**4,470**	3,570
	183,717	175,692	**262,303**	248,488	**446,020**	424,180
COSTS:						
Raw materials and manufacturing	**104,223**	100,576	**136,444**	134,914	**240,667**	235,490
Marketing and distribution	**32,037**	28,886	**85,747**	85,318	**117,784**	114,204
Administrative and general	**9,950**	8,302	**18,173**	17,090	**28,123**	25,392
Interest and expense on long term debt	**2,783**	2,920	**1,565**	1,401	**4,348**	4,321
Other interest	**2,593**	3,364	**1,190**	1,587	**3,783**	4,951
Foreign exchange	**—**	—	**(678)**	180	**(678)**	180
	151,586	144,048	**242,441**	240,490	**394,027**	384,538
	32,131	31,644	**19,862**	7,998	**51,993**	39,642
INCOME TAXES:						
Current	**12,453**	12,195	**5,392**	1,025	**17,845**	13,220
Deferred	**66**	1,427	**2,578**	2,169	**2,644**	3,596
	12,519	13,622	**7,970**	3,194	**20,489**	16,816
	19,612	18,022	**11,892**	4,804	**31,504**	22,826
MINORITY INTEREST	**—**	—	**7,029**	3,443	**7,029**	3,443
EARNINGS FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY ITEMS	**$ 19,612**	$ 18,022	**$ 4,863**	$ 1,361	**$ 24,475**	$ 19,383

CONSOLIDATED FINANCIAL POSITION

	March 31 1978	March 31 1977 (restated)
INVENTORIES:		
Tobacco—		
Leaf tobacco (including purchase advances of $37,959 in 1978)	**$ 76,810**	$ 80,481
Finished stock	**39,029**	26,310
Packaging material and other	**8,841**	6,822
	124,680	113,613
Brewing—		
Beverage products, finished and in process	**29,257**	30,264
Materials and supplies	**9,429**	9,979
Containers	**8,284**	8,375
	46,970	48,618
	$171,650	$162,231

ROTHMANS OF PALL MALL CANADA LIMITED
AND SUBSIDIARY COMPANIES

Line of Business Data
(in thousands of dollars)

CONSOLIDATED FINANCIAL POSITION

	March 31 1978 Cost	March 31 1978 Accumulated depreciation	March 31 1977 Cost	March 31 1977 Accumulated depreciation (restated)
PROPERTY, PLANT AND EQUIPMENT:				
Tobacco—				
Land	$ 2,544	$ —	$ 2,541	$ —
Buildings	6,568	2,697	6,288	2,524
Machinery, furniture and fixtures	39,685	22,979	39,322	21,332
Motor vehicles	4,861	2,963	4,621	2,842
Leasehold improvements	7,317	4,461	6,850	3,806
	60,975	33,100	59,622	30,504
Brewing—				
Land	6,096	—	6,125	—
Buildings	64,550	21,678	60,605	22,658
Machinery and equipment	95,690	57,391	99,961	62,639
Motor vehicles	11,496	5,666	12,232	5,581
Oil and gas properties	28,721	4,781	23,011	3,868
Leasehold improvements	1,209	611	1,208	605
	207,762	90,127	203,142	95,351
	$268,737	$123,227	$262,764	$125,855

	March 31 1978	March 31 1977
BANK INDEBTEDNESS AND NOTES PAYABLE:		
Bank indebtedness—		
Tobacco	$ 39,411	$ 32,226
Brewing	2,269	32,720
	41,680	64,946
Notes payable—Tobacco	12,828	16,000
	$ 54,508	$ 80,946
LONG TERM DEBT:		
Sinking Fund Debentures—		
Rothmans of Pall Mall Canada Limited—		
Series A 8% due January 3, 1988	$ 8,565	$ 9,397
Series B 11% due February 15, 1995	17,600	18,400
	26,165	27,797
Carling O'Keefe Limited—		
Series A 4¾% due January 15, 1979	600	1,186
Series B 4¼% due January 15, 1981	2,071	2,577
Series C 5% due January 15, 1983	2,826	3,008
Series D 5½% due April 1, 1986	5,533	7,026
Series E 5½% due April 1, 1989	8,059	11,126
	19,089	24,923
Term bank loan—		
Carling O'Keefe Limited due March 31, 1985	7,000	—
	52,254	52,720
Less: Amount included in current liabilities	3,012	3,070
	$ 49,242	$ 49,650

Notes to Consolidated Financial Statements

MARCH 31, 1978 AND 1977

1. Summary of significant accounting policies:

PRINCIPLES OF CONSOLIDATION:

The consolidated financial statements include the accounts of the Company and all of its subsidiaries, with the exception of Carling National Breweries, Inc. and its wholly-owned subsidiary which have been accounted for on the equity basis (Note 3). Purchase accounting has been followed for all acquisitions and the results of operations of subsidiaries are included from effective dates of acquisition.

For certain brewing subsidiaries acquired prior to April 1, 1974, the excess of the cost of shares over the recorded value of underlying net tangible assets at dates of acquisition is carried at cost and is not amortized. In accordance with current accounting practice, intangible assets acquired subsequently are amortized over periods not exceeding forty years.

FOREIGN EXCHANGE:

Foreign currency accounts are translated to Canadian dollars as follows: current accounts at exchange rates in effect at March 31; other balance sheet accounts and depreciation expense at historical rates of exchange; income and other costs at average rates of exchange during the year. The resulting exchange gains or losses are included in the consolidated statement of earnings.

INVENTORIES:

Except for containers, inventories are stated at the lower of average cost and net realizable value. Containers are recorded at amortized cost which is lower than new replacement cost.

PROPERTY, PLANT AND EQUIPMENT:

Depreciation is recorded on the straight-line basis over the estimated service lives of the assets, which are as follows for the principal asset categories:

Buildings—15 to 50 years

Machinery, furniture and fixtures—5 to 20 years

Motor vehicles—3 to 10 years

Leasehold improvements—term of lease, not to exceed 10 years

Oil and gas properties are accounted for on the full cost method, whereby all costs of exploration and development are capitalized and amortized against income using the unit of production method based on proven oil and gas reserves.

OTHER ASSETS:

Other assets are recorded at cost or amortized cost.

PENSIONS:

Current service costs are charged to operations as they accrue. Prior service costs arising from amendments to the plans and actuarial gains or losses are charged to operations as they are funded in accordance with legal requirements over periods ranging from five to fifteen years.

RESEARCH AND DEVELOPMENT:

Research and development expenditures are charged to operations as incurred.

MARKETING:

Marketing costs, including those related to the introduction of new brands, are charged to operations during the year in which they are incurred.

INCOME TAXES:

Income taxes are accounted for on the tax allocation basis for all timing differences between accounting and taxable income. These timing differences arise principally between accounting and tax depreciation.

2. Line of business reporting:

In these statements, all references to "brewing" relate to all activities of the Company's majority-owned (50.1%) subsidiary, Carling O'Keefe Limited, which include the production and sale of beer and wine and also the oil and gas operations. Details by line of business of consolidated operating results from continuing operations and certain consolidated assets and liabilities are shown on pages 20 and 21.

3. Sale of investment in United States brewing subsidiary:

On December 30, 1977, Carling O'Keefe sold Carling National Breweries, Inc., including its subsidiary Century Importers Inc., for $30,000,000 cash to R & R Holdings Limited, Soc. An., a member of the Rothmans World Group. The sale resulted in a loss of $12,093,000, as follows:

Investment at equity:	
Balance March 31, 1977	$ 50,910,000
Advances during the period	1,105,000
	52,015,000
Operating loss for the period	(10,157,000)
Balance December 30, 1977	41,858,000
Proceeds, net of costs	29,765,000
Loss on sale	$(12,093,000)

The loss on sale of the investment has been shown as an extraordinary item and is not available to be offset against taxable income.

Prior to the sale, Carling National Breweries, Inc. paid $740,000 to The O-W Fund, Inc., successor to The National Brewing Co., and obtained a release from any obligation for additional consideration under the terms of the original purchase agreement for the brewing assets and trademarks of The National Brewing Co. Mr. J. C. Hoffberger, a director of Carling O'Keefe at the time of the transaction, is a shareholder and a director of The O-W Fund, Inc.

In order to provide comparative financial statements which relate to the continuing operations, the 1977 amounts have been restated to account for the investment in the former United States brewing subsidiary on the equity basis. Sales from United States brewing operations were $186,189,000 for the nine months ended December 30, 1977 and $221,531,000 for the year ended March 31, 1977.

4. Minority interest in subsidiary companies:

The interest of minority shareholders in consolidated earnings or losses from continuing operations was as follows:

	1978	1977
		(restated)
CARLING O'KEEFE LIMITED:		
Preference shares	$ 2,107,000	$ 2,117,000
Common shares	4,839,000	1,355,000
	6,946,000	3,472,000
JORDAN VALLEY WINES LIMITED:		
Common shares	83,000	(29,000)
	$ 7,029,000	$ 3,443,000

The minority shareholders' interest in the capital stock and retained earnings of subsidiary companies is as follows:

	1978	1977
CARLING O'KEEFE LIMITED:		
Preference shares	$ 43,283,000	$ 43,538,000
Common shares	50,240,000	55,509,000
	93,523,000	99,047,000
JORDAN VALLEY WINES LIMITED:		
Common shares	1,731,000	1,648,000
	$ 95,254,000	$100,695,000

5. Earnings per Common share:

During the year ended March 31, 1978, 200 Second Preferred shares were converted into 160 Common shares and 25,000 Common shares were issued through exercise of warrants. The 1978 earnings per Common share figures have been calculated using the weighted average number of shares outstanding during the year (4,564,869) after giving effect to the conversion and the warrant exercise. The 1977 earnings per share figures are based on the 4,557,928 shares which were outstanding during the year ended March 31, 1977. Dividends earned on Preferred shares were deducted from consolidated earnings for purposes of this calculation.

Assuming conversion of outstanding Second Preferred shares and exercise of the 25,000 warrants as at April 1, 1977, earnings per Common share on a fully diluted basis for the year ended March 31, 1978 would have been $3.86 from continuing operations, $3.02 before extraordinary items and $2.18 after extraordinary items.

6. Other assets:

	1978	1977
		(restated)
Unamortized cost of shares of Carling O'Keefe subsidiaries in excess of underlying net tangible asset values at acquisition	$11,493,000	$14,485,000
Mortgages and long term receivables	7,178,000	1,045,000
Sundry properties	635,000	7,766,000
Unamortized deferred charges, trademarks and patents, investments and other	6,760,000	7,216,000
	$26,066,000	$30,512,000

Amortization of other assets amounted to $143,000 for the year ended March 31, 1978 (1977—$177,000).

On February 21, 1978, Carling O'Keefe sold its property located at Yonge and Front Streets, Toronto for $8,100,000. The consideration included a first mortgage of $6,885,000 due in 1981.

7. Bank indebtedness and notes payable:

Bank indebtedness of $39,411,000 (1977—$32,226,000) arising from tobacco operations is secured by the related accounts receivable and inventories.

8. Long term debt:

Long term debt consists of Sinking Fund Debentures of the Company ($24,650,000) and Carling O'Keefe Limited ($17,592,000) and a term bank loan of Carling O'Keefe Limited ($7,000,000). The remaining principal requirements for the years ending March 31, 1979 through 1983 are as follows:

	1979	1980	1981	1982	1983
Rothmans of Pall Mall Canada Limited	$1,515,000	$1,600,000	$1,600,000	$1,600,000	$1,600,000
Carling O'Keefe Limited	1,497,000	2,732,000	2,860,000	3,800,000	3,800,000
	$3,012,000	$4,332,000	$4,460,000	$5,400,000	$5,400,000

The Rothmans debentures and the Carling O'Keefe Series C, D and E debentures are payable in Canadian funds. The Carling O'Keefe Series A and B debentures are payable in either Canadian or U.S. funds at par, at the option of the holder. The Rothmans debentures are secured by a floating charge on the Company's assets in the Provinces of Ontario and Quebec.

In June 1977, Carling O'Keefe arranged a term bank loan of $7,000,000, bearing interest until March 31, 1979 at 1¼% over the bank's prime rate and thereafter at 1% over prime. The loan is repayable in varying instalments up to March 31, 1985.

9. Capital stock:

AUTHORIZED:

469,889 First Preferred shares of the par value of $100 each, issuable in series
2,817,062 Second Preferred shares of the par value of $20 each
7,950,000 Common shares without nominal or par value

ISSUED:

	1978	1977
159,098 6.85% Cumulative Redeemable First Preferred shares, Series A (1977—164,100)	$15,910,000	$16,410,000
1,841,862 6⅝% Convertible Cumulative Redeemable Second Preferred shares (1977—1,842,062)	36,837,000	36,841,000
	52,747,000	53,251,000
4,583,088 Common shares (1977—4,557,928)	4,159,000	3,590,000
	$56,906,000	$56,841,000

PURCHASES, CONVERSIONS AND ISSUES:

During the year ended March 31, 1978, 5,002 First Preferred shares with a total par value of $500,000 were purchased for cancellation at a cost of $420,000, 200 Second Preferred shares were converted into 160 Common shares and 25,000 Common shares were issued for $566,000 cash through exercise of warrants.

During the year ended March 31, 1977, 5,701 First Preferred shares were purchased for cancellation.

REDEMPTION AND CONVERSION PRIVILEGES:

The Series A First Preferred shares are not redeemable before January 27, 1979, but are redeemable on or after that date at the option of the Company at a premium of $3 per share if redeemed before January 27, 1984, of $2 per share if redeemed before January 27, 1989, and of $1 per share if redeemed on or after January 27, 1989. The Company is required to purchase 5,000 of these shares in each calendar year. At March 31, 1978, 902 shares of the 1978 requirement had been acquired.

The Second Preferred shares are not redeemable before November 1, 1979, but are redeemable on or after that date at the option of the Company at par. These shares are convertible on the basis of 1 Common share for 1¼ Preferred shares converted on or before October 31, 1979. Thereafter, the Second Preferred shares will not be convertible into Common shares of the Company.

The Series A Debentures and the Series A Preferred shares were issued with warrants to purchase Common shares of the Company. The 324,970 warrants outstanding expired January 3, 1978.

Of the authorized and unissued Common shares, 1,473,490 shares are reserved for the conversion of Second Preferred shares.

OWNERSHIP:

Rothmans of Canada Limited presently owns 85.6% of the Company's issued Common shares and 15.7% of the issued Series A First Preferred shares. Rothmans of Canada has confirmed its intention to reduce its Common shareholdings to 50% at some future date.

10. Retained earnings:

Under Section 62 of the Canada Corporations Act, $1,079,000 of retained earnings at March 31, 1978 is designated as capital surplus on the purchase for cancellation of 10,791 First Preferred shares.

Under the most restrictive provisions of the covenants relating to the Debentures and the Preferred shares, the Company cannot declare dividends on Common shares unless, after providing for them, consolidated retained earnings will be not less than $6,000,000 and all dividends on the Preferred shares have been declared and either paid or provided for.

11. Remuneration of directors and officers:

The remuneration paid to thirteen directors and fifteen officers (three of whom are also directors), who held their positions with the Company during the year ended March 31, 1978, was $89,000 and $858,000 respectively (1977—thirteen directors: $94,000 and twelve officers: $749,000). Of the total remuneration, $51,000 (1977—$50,000) was paid by Carling O'Keefe Limited.

12. Pensions:

The Company and its subsidiaries maintain a number of pension plans covering substantially all employees and it is the Company's policy to fund pensions with independent trustees. The charge against earnings from continuing operations was $5,434,000 for the year ended March 31, 1978 (1977—$5,434,000), including $4,035,000 (1977—$4,012,000) for employees in brewing operations.

Based on actuarial valuations, unfunded prior service costs for brewing operations are estimated at $2,900,000. These amounts are being funded over periods ranging from five to fifteen years, as described in Note 1.

Pension liabilities for tobacco operations are fully funded.

13. Commitments and contingent liabilities:

Under a long term agreement with United Breweries Limited of Copenhagen, Denmark, Carling O'Keefe and its affiliates have access to the brewing research and technical knowledge of United Breweries, together with the exclusive right to manufacture and sell brewery products under the Carlsberg and Tuborg trademarks in Canada, the United States and the Republic of Ireland. Royalties are payable based on total sales of all brewery products at rates varying with the volumes and selling prices of the products. The agreement is cancellable on twenty years' notice or earlier if certain specified conditions are not fulfilled.

On April 28, 1978, in consideration of a payment of $600,000 to the minority shareholders of Jordan Valley Wines Limited, the commitment of Carling O'Keefe to acquire the minority interest (8.1%) has been extended to the 1982 fiscal year. The

purchase price will be at least equal to $2,993,000. Mr. N. Torno, a director of Carling O'Keefe, and a member of his family hold the minority shares.

During the 1977 fiscal year, Carling O'Keefe acquired for $2,000,000 cash a 40% interest in a partnership which owns the Toronto Argonaut Football Club. Under certain circumstances, and subject to certain conditions, Carling O'Keefe may be obliged to acquire the remaining interest in the partnership on similar terms.

Capital expenditures for the year ending March 31, 1979 are estimated at $31,000,000, of which $23,500,000 relates to brewing operations.

To ensure an adequate supply of Ontario flue-cured tobacco, the Company, together with the other major Canadian cigarette manufacturers, has agreed to purchase a specified quantity of the 1978 Ontario crop at a guaranteed minimum average price.

There are a number of outstanding claims and legal actions involving the Company and its subsidiaries. In the opinion of management, the outcome of these matters should have no material adverse effect on the Company's financial position.

14. Anti-inflation legislation:

The Company and its Canadian subsidiaries are subject to, and believe that they have complied with, controls on prices, profits, dividends and compensation instituted by the Government of Canada in the Anti-Inflation Act, effective October 14, 1975. To comply with the controls, Common share dividends paid by the Company prior to October 13, 1978 may not exceed $1.00 per share on an annual basis.

Price Waterhouse & Co.
CHARTERED ACCOUNTANTS

Box 51 Toronto-Dominion Centre
Toronto, Ont. M5K 1G1
(416) 863-1133 Telex 065-24111

May 18, 1978

AUDITORS' REPORT

TO THE SHAREHOLDERS OF
ROTHMANS OF PALL MALL CANADA LIMITED:

We have examined the consolidated statements of earnings, retained earnings and changes in financial position of Rothmans of Pall Mall Canada Limited for the year ended March 31, 1978 and the consolidated balance sheet as at that date. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the results of operations and the changes in financial position of the Company for the year ended March 31, 1978 and its financial position as at that date in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Price Waterhouse & Co.

Chartered Accountants

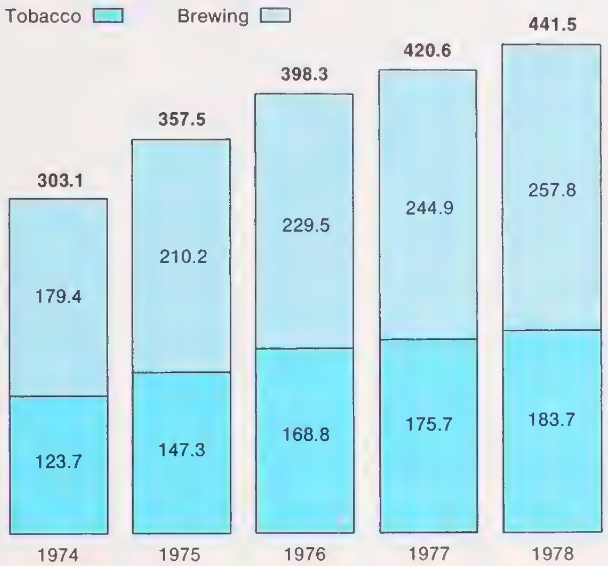
Five-Year Financial Review

	Year Ended				
	March 31			June 30	
	1978	*1977* (restated)	*1976* (restated)	*1975* (restated)	*1974* (restated)
Results for the Year (in thousands of dollars):					
Sales from continuing operations—					
Tobacco	**$398,751**	$394,484	$385,406	$344,134	$300,889
Brewing	**381,147**	359,189	343,511	322,533	285,954
	779,898	753,673	728,917	666,667	586,843
Excise and sales taxes	**338,348**	333,063	330,639	309,183	283,733
	441,550	420,610	398,278	357,484	303,110
Earnings—					
Earnings before income taxes—					
Tobacco	**32,131**	31,644	37,578	30,648	22,267
Brewing	**19,862**	7,998	14,967	10,430	3,029
	51,993	39,642	52,545	41,078	25,296
Income taxes	**(20,489)**	(16,816)	(20,315)	(15,786)	(10,946)
Minority interest	**(7,029)**	(3,443)	(6,390)	(5,130)	(2,002)
Earnings from continuing operations	**24,475**	19,383	25,840	20,162	12,348
Loss from operations of former United States brewing subsidiary, less minority interest	**(5,091)**	(51)	(4,756)	(4,361)	(3,306)
Earnings before extraordinary items	**19,384**	19,332	21,084	15,801	9,042
Extraordinary items, less minority interest	**(5,118)**	336	(73,255)	(71,570)	772
Earnings (loss)	**14,266**	19,668	(52,171)	(55,769)	9,814
Depreciation—continuing operations	**12,367**	11,397	11,283	10,865	9,920
Interest expense—continuing operations	**8,066**	9,170	8,835	9,434	8,429
Dividends paid—					
Preferred	**3,547**	3,581	3,604	4,592	7,541
Common	**3,028**	2,370	2,279	1,910	802
Financial Position (in thousands of dollars):					
Working capital	**$118,467**	$ 64,980	$ 64,291	$ 71,100	$ 44,526
Property, plant and equipment—net	**145,510**	136,909	127,078	124,672	121,541
Investment in United States brewing subsidiary, at equity	**—**	50,910	49,782	46,053	47,776
Other assets	**26,066**	30,512	29,214	29,252	103,709
Total assets	**415,854**	432,494	398,982	389,032	444,509
Bank indebtedness and notes payable	**54,508**	80,946	71,748	56,162	76,510
Long term debt	**49,242**	49,650	55,050	59,639	44,873
Deferred income taxes	**28,493**	23,799	20,203	18,307	15,604
Minority interest in subsidiaries	**95,254**	100,695	99,317	104,904	106,518
Shareholders' equity	**117,054**	109,167	95,795	88,227	150,557
Per Common Share:					
Earnings (loss)—from continuing operations	**$ 4.58**	$ 3.47	$ 4.88	$ 4.01	$ 3.00
—before extraordinary items	**3.47**	3.46	3.84	2.90	0.94
—after extraordinary items	**2.35**	3.53	(12.24)	(15.36)	1.42
Dividends paid	**0.663**	0.52	0.50	0.50	0.50
Shareholders' equity	**14.00**	12.24	9.18	7.52	23.23
Ratios and Statistics:					
Return on average total capital employed (%)—					
Tobacco	**17.0**	18.6	24.9	23.3	21.3
Brewing	**8.4**	4.8	7.3	6.2	2.3
Capital expenditures ($000)	**26,056**	22,199	17,709	15,764	17,416
Working capital from continuing operations ($000)	**47,042**	37,610	45,532	38,297	25,357
Debt to capital ratio (%)—					
Tobacco	**52**	56	62	68	76
Brewing	**23**	32	28	27	30
Working capital ratio	**1.94**	1.44	1.50	1.60	1.35
Number of common shares outstanding (thousands)	**4,583**	4,558	4,558	4,558	1,604

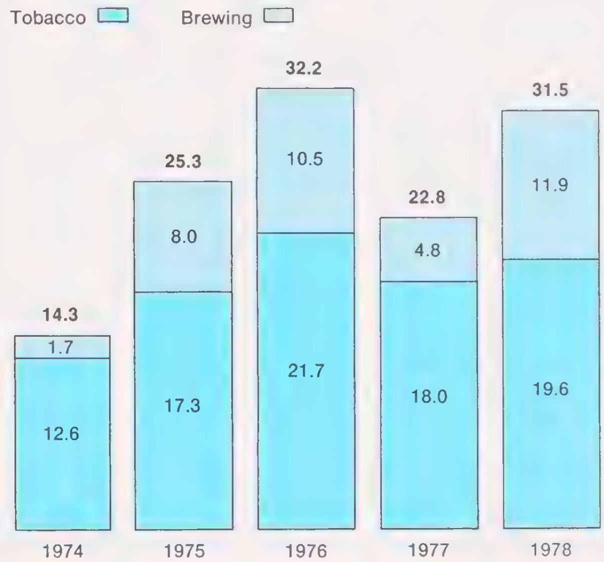
Notes: (1) Comparative amounts have been restated to account for the former United States brewing subsidiary on the equity basis.

(2) The fiscal year-end of the Company and its subsidiaries was changed from June 30 to March 31, effective in 1976. Comparative amounts for 1976 are for the twelve months ended March 31.

Sales From Continuing Operations
(Excluding Excise & Sales Taxes)
$ Millions

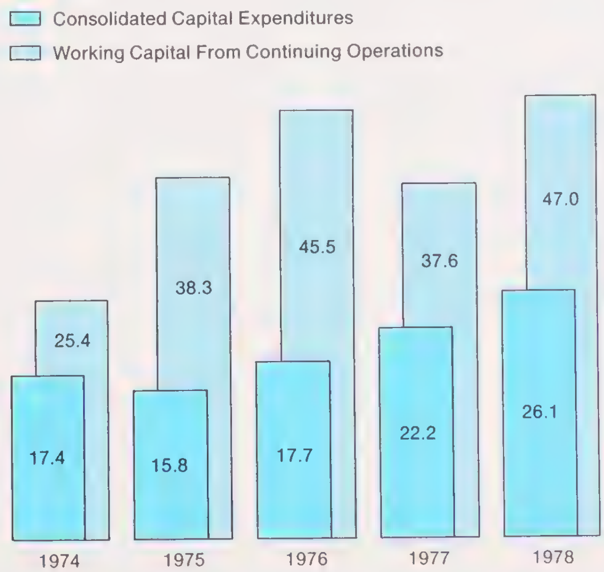


Earnings From Continuing Operations
(Before Extraordinary Items, Including Minority Interest)
$ Millions



Dividends Paid and Consolidated Earnings
Per Share From Continuing Operations

Consolidated Capital Expenditures and
Working Capital From Continuing Operations
$ Millions



Quarterly Financial Data—Continuing Operations

(in thousands of dollars)

CONSOLIDATED SALES

	Year Ended March 31	
	1978	1977 (restated)
Quarter ended—		
June 30	**$199,703**	$194,589
September 30	**207,911**	201,938
December 31	**209,127**	193,579
March 31	**163,157**	163,567
	$779,898	$753,673

CONSOLIDATED EARNINGS BEFORE EXTRAORDINARY ITEMS

	1978	1977
AMOUNT:		
Quarter ended—		
June 30	**$ 5,655**	$ 4,772
September 30	**6,709**	5,338
December 31	**8,227**	6,069
March 31	**3,884**	3,204
	$ 24,475	$ 19,383
PER COMMON SHARE:		
Quarter ended—		
June 30	**$ 1.05**	$ 0.85
September 30	**1.28**	0.98
December 31	**1.60**	1.13
March 31	**0.65**	0.51
	$ 4.58	$ 3.47

Officers

JOHN H. DEVLIN
Chairman of the Board

ROBERT H. HAWKES, Q.C.
President and Chief Executive Officer

ROY H. NEWTON
Senior Vice President Operations

ROBERT W. ALLAN, C.A.
Vice President Materials Management

ROBERT I. P. CAMERON
Vice President Advertising

DANIEL DI IANNI
Vice President Manufacturing

GORDON R. WHITE
Vice President Sales

C. PAUL YOUNG
Senior Vice President Corporate Services

CAMILLE A. DENIS
Vice President Corporate Affairs

GERALD G. NORMAN
Vice President Human Resources

HUGH R. SAMPSON, C.A.
Vice President and Treasurer

CHERRY G. FERGUSON
Secretary and General Counsel

DOROTHY I. L. WILLIAMS
Assistant Secretary

Directors

JOEL W. ALDRED, D.F.C.

GEORGE E. CREBER, Q.C.

JOHN H. DEVLIN

ROBERT H. HAWKES, Q.C.

JOHN C. LOCKWOOD

GEORGE B. McKEEN

SIR DAVID NICOLSON

JOHN E. SHAFFNER

RONALD D. SOUTHERN

C. PAUL YOUNG

AUDIT COMMITTEE

JOEL W. ALDRED, D.F.C.

ROBERT H. HAWKES, Q.C.

JOHN E. SHAFFNER

COMPENSATION COMMITTEE

JOEL W. ALDRED, D.F.C.

GEORGE E. CREBER, Q.C.

PENSION INVESTMENT COMMITTEE

EDWARD A. CRIGHTON, C.A.

GEORGE B. McKEEN

HUGH R. SAMPSON, C.A.

C. PAUL YOUNG

Head Office • 75 DUFFLAW ROAD, TORONTO, ONTARIO, M6A 2W4

Auditors • PRICE WATERHOUSE & CO.

Bankers • BANK OF MONTREAL

Registrar and Transfer Agent • THE ROYAL TRUST COMPANY

Solicitors • SMITH, LYONS, TORRANCE, STEVENSON & MAYER

MARKET PRICES

The Company's Preferred and Common shares are listed on the Toronto, Montreal and Vancouver Stock Exchanges. The following table sets forth, for the fiscal periods indicated, the high and low sales prices of the Preferred and Common shares.

		1978				1977			
		4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
First Preferred	–High	$84	$86	$86	$82⅜	$75	$73	$71	$70
	–Low	81½	82¼	81½	75	70¼	69	68	66¾
Second Preferred	–High	17⅜	17⅜	16⅝	16⅜	15¾	15¼	15½	16¼
	–Low	15¾	16	16	14¼	14⅛	14	14½	14½
Common	–High	20	19	14½	14½	16¼	16	16⅞	18¼
	–Low	17	12½	13	11⅞	15	13½	14	16

VALUATION DAY PRICES

For Canadian capital gains tax purposes, the valuation day values of Rothmans of Pall Mall Canada Limited securities were as follows:

8% Debentures due January 3, 1988	$93
First Preferred Shares, Series A	$82½
Second Preferred Shares	$19⅞
Warrants	$ 3½
Common Shares	$16⅝

Rothmans of Pall Mall
Canada Limited